TAX SECTION
State Bar of Texas

September 22, 2022

Via Federal eRulemaking Portal at *www.regulations.gov*

Internal Revenue Service
CC:PA:LPD:PR (REG-130975-08)

RE: ***Comments on Proposed Regulations under Section 2053***

Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury (the "Treasury") and Internal Revenue Service (the "IRS" or "Service") in the Notice of Proposed Rulemaking (REG-130975-08) issued on June 28, 2022 (the "Proposed Regulations"). The Proposed Regulations propose amendments to existing regulations under Section 2053 regarding the deductibility of interest expense accruing on tax and penalties owed by an estate, and interest expense accruing on certain loan obligations incurred by an estate. The Proposed Regulations also propose amendments related to the use of present value principles in determining the amount deductible by an estate for funeral expenses, administration expenses, and certain claims against the estate.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury and the Service for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Henry Talavera

Henry Talavera, Chair
State Bar of Texas, Tax Section

Enclosure

COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 2053

These comments on the Proposed Regulations (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Carol G. Warley, Chair, Estate and Gift Committee, with substantial assistance from Tandilyn S. Cain.[1] The principal reviewers of these Comments were Carolyn Starr and Sarah Marks, Vice Chairs, Estate and Gift Committee. Laurel Stephenson reviewed these Comments and made substantive changes. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Christi Mondrik, Chair of COGS, and Lee Meyercord, Co-Chair of COGS reviewed these Comments and made substantive suggestions on behalf of COGS. Henry Talavera, Chair of the Tax Section, reviewed the Comments.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: September 22, 2022

[1] Ms. Cain is a Manager in RSM US LLP Washington National Tax but is not a member of the State Bar of Texas.

INTRODUCTION

These Comments are provided in response to the Treasury's and the Internal Revenue Service's request for comments regarding the Proposed Regulations, which would require the deductible amount of certain administration expenses paid more than three years after the decedent's death to be computed by applying present value principles. The Proposed Regulations also clarify the rules under Section 2053 addressing the deductibility of interest expense accruing on tax and penalties owed by an estate or incurred in conjunction with certain loan obligations incurred by an estate.[2]

The 2007 Proposed Regulations,[3] which preceded the 2009 Final Regulations, applied present value principles only to certain noncontingent, recurring obligations. The preamble to the 2009 Final Regulations indicated that the Treasury and the IRS found persuasive criticism of those proposed rules by commenters suggesting that they produced an inconsistent and inequitable result.[4] The 2009 Final Regulations removed the present value limitation applicable only to noncontingent, recurring obligations and reserved Treasury Regulations §20.2053-1(d)(6) to provide future guidance on the issue.[5] The current Proposed Regulations propose to discount the amounts actually paid or to be paid after an extended post-death time period to determine the present value of the payments in order to reduce the gross estate only by the amounts not passing to the heirs and legatees by applying that principle consistently to expenses and claims. The 2009 Final Regulations clarify that events occurring after date of death will be taken into consideration in determining the allowable deduction under section 2053.[6]

We appreciate the opportunity to comment on the Proposed Regulations.

APPLICATION OF PRESENT VALUE PRINCIPLES TO AMOUNT DEDUCTIBLE UNDER SECTION 2053

A. Three-year Grace Period

Proposed Regulations Section 20.2053-1(d)(6)(i)(A)(1) provides for a three-year "grace period" during which claims and expenses otherwise meeting the requirements for deductibility under Section 2053 and the corresponding regulations may be deducted without applying present value principles. We appreciate the Treasury and IRS sharing the considerations taken into account in drafting the three-year "grace period." While we readily agree with the Treasury and the IRS that estates often incur deductible claims and expenses well after the decedent's death, our experience diverges substantially from the statement in the preamble in which the IRS indicates that "a significant percentage of estates pay most, if not all, of their ordinary estate administration

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[2] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended.

[3] TD 9468; 72 FR 20080

[4] TD 9468; 74 FR 53652

[5] TD 9468; 74 FR 53652

[6] Treas. Reg. §20.2053-1(d)(2)

expenses during the three-year period following the decedent's date of death."[7] While that statement is arguably correct for estates that are not required to file a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, the Treasury and the IRS might consider that executors of estates obligated to file a Form 706 will frequently not pay most of their ordinary estate administration expenses during this three-year "grace period" based upon our experience, which we suggest would be consistent with the experience of most practitioners.

For example, estates required to file a Form 706 are frequently complex, with many experiencing litigation (*e.g.*, will contests, judicial constructions or reformations of testamentary trusts, etc.) that inevitably delay termination of the estate beyond the proposed "grace period." Additionally, a significant percentage of estates required to file a Form 706 either experience, or at least must plan for the possibility of, an audit by the IRS, which requires the executor to retain most (if not all) estate assets and, thus, prevents an executor from paying all actually and necessarily incurred administration expenses within three years of the date of death. Generally, a well-advised executor properly mindful of his/her fiduciary duties will postpone distribution of most (if not all) of the estate's assets until the estate tax closing letter is obtained, which typically occurs well after the proposed "grace period."

Further, when an estate is selected for examination, the only method for extending the statute of limitations for the Form 706 is to initiate litigation. Even after the closing letter is received, a prudent executor will routinely have numerous time-intensive tasks to undertake before the estate's distribution, including, but not limited to:

(i) Preparing (and recording) deeds and other assignments, as well as securing related third-party consents;

(ii) Seeking a judicial release and discharge or alternatively preparing and negotiating with counsel for the beneficiaries a comprehensive distribution agreement summarizing the executor's actions taken in administering the estate and seeking the beneficiaries' release of the executor from fiduciary liability;

(iii) Coordinating the transfer of estate assets with the trustees of testamentary trusts in receipt of the estate assets.

Accordingly, the Treasury and the IRS should consider whether the proposed three-year "grace period" is not the "reasonable period of administration of the estate" for complex estates. The IRS might reasonably consider whether the "reasonable period of administration of the estate" is the period during which payments of otherwise deductible claims and expenses should be exempted from present value principles.

In that respect, the Treasury and IRS might reasonably consider extending the proposed "grace period" to a five-year period beginning at the decedent's date of death. That period would generally encompass the filing of Form 706 (with extensions), the three-year statute of limitations, and an additional nine months, which is a reasonable period of time for an executor of an estate

[7] 26 CFR Part 20 [REG-130975-08] RIN 1545-BI11

with the level of complexity typically associated with a Form 706 filing obligation to distribute its assets to the beneficiaries.

The Treasury and the IRS might also consider a further extension or tolling of the "grace period" where the estate is in litigation with the IRS, until at least the conclusion of that litigation and an additional nine months, which is a reasonable period of time for an executor to distribute assets to the beneficiaries after litigation. We suggest that the IRS might consider this extended "grace period" as better balancing the Treasury's and IRS's objective of "more accurately determining the amounts not passing to the beneficiaries of an estate garnered from applying present value principles," while meeting the additional shared interests of practitioners and the IRS in minimizing the "administrative burden of applying those principles to deductible claims and expenses that occur during a reasonable period of administration of the estate."[8]

B. Adjustment to Residue Charitable and Marital Estate Tax Deductions

Many estate plans have a marital or charitable deduction for the residue of the estate. Applying present value principles to otherwise deductible claims and expenses with no corresponding automatic adjustment to the impacted marital or charitable estate tax deduction, may result in an estate tax on a phantom asset.

In reapplying the present value principle, the Proposed Regulations appear to place additional burdens on the Service, taxpayers, and tax practitioners that are not specifically called for in the legislation. For example, Section 2053(a) provides that "the *value* of the taxable estate shall be determined by deducting from the *value* of the gross estate such amounts for funeral expenses, for administration expenses, for claims against the estate, and for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate" [emphasis added]. The Proposed Regulations would limit the deduction to the present value of the estate's expenses beyond the "grace period".

The phantom value included in the estate that does not qualify for a deduction creates risk that the additional value, which is not actually realized, will be taxed in the estate. Taxing phantom income does not comport with economic realities by taxing an asset that does not exist; this places an undue burden on the estate. For example, if the IRS examines an estate tax return, it is typically not concluded within the "grace period," as defined in the Proposed Regulations. In a situation where the value of the estate is increased under examination with the residue passing to charity, the charitable deduction will be determined based on the amount actually paid. If present value principles are applied to the underpayment interest on the estate tax deficiency and the charitable deduction is limited to the amount that is actually paid to charity, the difference between the interest expense allowed as an estate tax deduction and the amount actually paid would generate a phantom asset. This could trigger estate tax even though all amounts went to pay underpayment interest with the remainder passing to charity. Thus, the Treasury and IRS might want to clarify that the "present value discount" applied in such a situation does not reduce the deduction for the amount passing to the marital or charitable recipient. We believe that this is consistent with the

[8] 26 CFR Part 20 [REG-130975-08] RIN 1545-BI11

underlying principles of the Proposed Regulations to reduce from the value of the gross estate administration expenses that represent amounts that will not pass to heirs.

DEDUCTIBILITY OF INTEREST EXPENSE AS AN ADMINISTRATION EXPENSE

A. Actually and Necessarily Incurred Interest Expense

Proposed Regulations Section 20.3053-3(d)(1)(iii) provides that interest accruing on unpaid tax and penalties is "not deductible to the extent the interest expense is attributable to an executor's negligence, disregard of applicable rules or regulations (including careless, reckless, or intentional disregard of rules or regulations) as defined in §1.6662-3(b)(2), or fraud with intent to evade tax." The Treasury and the IRS might consider providing additional clarity and examples to help taxpayers and professionals understand which fact patterns will constitute a "disregard of applicable rules or regulations" (*i.e*. when the Treasury and the IRS believe interest expense will not qualify as a deductible administration expense under Section 2053).

Specifically, while we appreciate the inclusion of Proposed Regulations Section 20.2053-3(d)(1)(iv)(B), Example 2, the Service might consider expanding the example to address extenuating circumstances in which the Treasury and the IRS would find the interest expense deductible. For example, certain estates are involved in litigation with beneficiaries, or the beneficiaries are involved in litigation with each other, resulting in the inability to appoint an executor or the inability of the executor to obtain the information necessary to file a complete and accurate Form 706 by the due date. Ongoing litigation would seem to be the type of circumstance that would cause interest payments incurred to be actually and necessarily incurred for allowing the deduction for interest expense. The Example does not indicate why the executor's failure to file the Form 706 was due to a "disregard of rules for filing the return," as opposed to a situation created by a legitimate dispute.

Similarly, Proposed Regulations Section 20.2053-3(d)(1)(iv)(C), Example 3, concludes that the interest is not actually and necessarily incurred in the administration of the estate but does not indicate why the executor's failure was due to a "disregard of applicable rules or regulations," as opposed to a situation created by a legitimate dispute. Where there is a legitimate dispute regarding the validity of an assessment, interest accrued during the pending controversy would appear to be actually and necessarily incurred because a prudent executor would be bound to pursue legitimate challenges to alleged liabilities. For example, for federal tax, the amount is usually in dispute before any tax, penalty or internet is assessed. For state and local tax, the liabilities are often assessed before a taxpayer can even challenge them. Just because the amount is ultimately fully or partially upheld doesn't necessarily mean there was not a valid dispute, especially where the law or regulations were uncertain and court action was necessary to determine the result. Tax liabilities are generally not considered delinquent until after the taxpayer has had opportunities to challenge an assessment or proposed deficiency. Interest incurred related to other litigation, such as beneficiary litigation, could involve similar issues. The Treasury and the IRS might consider elaborating in the Example why the executor's failure was a result of a "disregard of applicable rules or regulations." In our experience, engaging in a legitimate dispute is not generally considered disregarding under the applicable rules or regulations.

Additionally, the Proposed Regulations confirm that Section 6166 interest is non-deductible but is calculated at a favorable interest rate. The statute provides this beneficial treatment in situations where the estate meets the requirements under Section 6166 with respect to its closely held business interests. The Treasury and the IRS might consider not applying present value concepts to interest paid by estates that have received an extension of time to pay estate tax under Section 6161, because the interest expense is actually and necessarily incurred. The Proposed Regulations Section 20.2053-1(d)(1) provides that "when non-Section 6166 interest accrues on unpaid estate tax deferred under Section 6161 or Section 6163, the interest expense is actually and necessarily incurred in the administration of the estate for purposes of paragraph (a) of this Section, because the extension was based on a demonstrated need to defer payment." The Service might consider that estates granted a Section 6161 extension should receive a similar benefit offered to estates under Section 6166, because of the illiquid nature of those estates is similar to the illiquid nature of estates that have been granted a Section 6166 extension.

B. Factors to Consider for Loan Obligations

The Proposed Regulations Section 20.2053-1(d)(2) provides eleven factors, "that collectively may support a finding that the interest expense also satisfies the additional requirements under § 20.2053–1(b)(2) and paragraph (a) of this section."

Proposed Regulations Section 20.2053-1(d)(2)(ix) and (x) provide that a loan from a substantial beneficiary, an entity controlled by a substantial beneficiary, or a beneficiary whose individual share of liability under the loan is substantially similar to his or her share of the estate are factors that should be considered when determining whether interest expense meets the requirements for deductibility under Proposed Regulations Section 20.2053-1(b)(2). The Treasury and the IRS might consider the impact which this would have on the many estates that are illiquid and, thus, unable to obtain a commercial loan due to such illiquidity or restrictions on the use of certain estate assets as collateral for third-party loans due to governing document limitations (*e.g.*, private equity interests).

Even if a commercial loan is a possibility, the related closing costs and regulatory compliance measures may be prohibitively time consuming and expensive for a highly illiquid estate lacking the funds needed to pay estate taxes within nine months of the decedent's death. By necessity and in our experience, executors often obtain the requisite funds in a more timely manner via *bona fide* loans from entities owned by beneficiaries or trusts for the benefit of similar or the same beneficiaries at interest rates competitive with, or less than, those of commercial lenders, but without the prohibitive closing costs and compliance-related time constraints.

The Treasury and the IRS might consider that the existing case law has typically provided that the loan is considered *bona fide* and actually and necessarily incurred when made by a beneficiary related lender loan.[9] We cite three cases below as illustrative. For example, in *Estate*

[9] *Estate of Graegin v. Comm'r*, T.C. Memo 1988-477 (finding that a loan was actually and necessarily incurred to pay taxes to prevent the forced sale of assets); *c.g. Estate of Samuel Black v. Commissioner,* 133 T.C. No. 15 (finding that interest on the loan was not deductible because it was not necessary); *Estate of Todd v. Commissioner*, 57 T.C. 288 (finding that loans from a family-owned entity were necessary to avoid a forced sale of assets)

of Graegin, the factors that were considered to determine if the loan was *bona fide* and actually and necessary included:

(a) The terms of the note;

(b) Security on the amount loaned;

(c) Genuine illiquidity in the estate; and

(d) Treatment by the lender.

Next, in *Estate of Todd v. Commissioner*, a loan to cover estate taxes was made by a family-owned entity and found to be actually and necessarily incurred as well. Last, in *Estate of Black*, the interest on the loan was held not to be deductible because it was not necessary.

A life insurance trust is an example of a potential beneficiary related loan. Beneficiaries of a life insurance trust may (or may not) be the same beneficiaries of the estate. The decedent may have recognized liquidity issues that would impact the ability of their estate to pay the estate tax due within nine months of the date of death. The decedent may have created a life insurance trust during their lifetime to provide the necessary liquidity at death due to the receipt by the trust of the life insurance proceeds.

In our experience, in the case of a life insurance trust, the trustee of that trust would then be able to enter into a loan with the estate to provide the liquidity for the estate to pay the estate tax due. The trustee would have a fiduciary obligation to charge a market interest rate, obtain the proper collateral and provide to reasonable terms where loan repayment would reasonably be obtained. The Treasury and the Service might consider that this type of loan made by a fiduciary, where an estate is illiquid, should generally be treated as a *bona fide* and actually and necessarily incurred

Finally, Proposed Regulations Section 20.2053-1(d)(2)(vii) provides that the liquidity of entities that the estate has deemed control over should also be a factor to consider when making the determination of whether interest expense meets the requirements for deductibility under Proposed Regulation Section 20.2053-1(b)(2). The Treasury Department and the IRS might consider whether to remove that factor or provide more flexibility in that case. For example, if the estate held a 51% ownership of an operating business, with the remaining interests held by unrelated third parties, utilizing the entity's liquid assets could result in litigation by the other owners. There is also established case law that provides an estate with the right to obtain a loan for estate tax and to retain assets for future appreciation.[10] The estate may also have literal control over the entity without having practical and effective control. Also, the entity may have working capital needs that prevent its assets from being used to pay estate tax. In these situations, such factor might be appropriate only when practical and effective control is shown based upon the facts and circumstances, and in such case, only when the illiquidity cannot be reasonably avoided.

[10] *McKee v. Commissioner*, T.C. Memo. 1988-362 (finding that an estate could retain the lender's stock for future appreciation rather than be forced to sell the assets to cover taxes owed)